

Internal Revenue Service
memorandum

CC:TL:Br3
FJElward

date: **AUG 19 1986**

to: District Counsel, Los Angeles W:LA

from: Director, Tax Litigation CC:TL

subject: Section 6653(b)(2)

Technical Advice.

Your transmittal of June 27, 1986, forwarded a proposed memorandum to the Acting Chief, Centralized Quality Review, and requested our views.

ISSUE

If the taxpayer does not file a timely return, but files one before the notice of deficiency is issued, is the penalty interest portion of the fraud penalty, I.R.C. section 6653(b)(2), computed on the deficiency only, or should it be computed on the entire underpayment even though the taxpayer filed a delinquent return and paid the tax reported.

CONCLUSION

The 6653(b)(2) penalty is 50% of the interest on the entire underpayment (tax liability) for the period from the due date of the return to the date the tax is paid (assuming the entire underpayment is due to fraud). Thus if the entire tax is paid with a delinquent return and the Service assesses the reported tax, the penalty is equal to 50% of the interest imposed by section 6601.

FACTS

Under the facts stated in your memorandum, the taxpayer does not file a timely return. However, before the notice of deficiency is issued, he files a delinquent return and pays some or all of the tax determined to be due on audit. The notice determines that the taxpayer fraudulently failed

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to pay the entire tax and determines penalties under section 6653(b)(1) and (b)(2). The penalty under section 6653(b)(1) is computed on the entire underpayment (tax liability) pursuant to section 6653(c), even though the taxpayer has filed a return since the return was not timely. In computing interest on the tax liability under section 6601, the interest imposed is computed on the unpaid tax for the period beginning with the due date of the return, when the tax should have been paid, and ending with the date the tax is paid.

In your proposed memorandum, you conclude that the penalty under section 6653(b)(2) should be computed on the underpayment, as defined in section 6653(c), the entire tax liability, without reduction for the tax reported on the delinquent return.

ANALYSIS

Section 6653(b) imposes two penalties for fraudulent underpayment of tax. The first, imposed by subsection (b)(1), is based on 50% of the deficiency if the balance of the tax was reported on a timely return, or 50% of the underpayment (entire tax liability), if the return was delinquent. The other part of the fraud penalty, imposed by subsection (b)(2), is an amount equal to 50% of the interest imposed under section 6601(a) on the portion of the underpayment due to fraud. For purposes of section 6653, the term "underpayment" is defined in subsection 6653(c) as the deficiency, but only if the balance of the tax is reported on a timely return.

Section 6601 imposes interest on a taxpayer where he fails to pay a tax liability imposed by the Code when payment is due. Generally, the interest runs from the date the tax should have been paid to the date the tax is paid. However, interest is assessed in the same manner as the tax to which it relates. Although interest is not subject to the deficiency procedures, if the tax cannot be assessed due to restrictions on assessment, section 6211 et seq., interest cannot be assessed until the tax can be assessed. Therefore, where the taxpayer files a return, the tax reported on the return may be assessed and the interest may also be assessed. If the tax reported on a delinquent return is assessed, interest will be assessed on the tax

assessment. Full payment of the tax and interest assessment will prevent further interest from accruing under section 6601.

Thus, if the taxpayer files a delinquent return and pays the tax reported, only the difference between the correct liability and the tax previously assessed (reported) need be set forth in a notice of deficiency. If the tax reported, even on a delinquent return, equals the correct liability, and the Service assesses the reported tax, there is no deficiency. However, if the Service determines the liability was underpaid due to fraud, it must issue a notice, before assessing the penalty. Thus under certain circumstances the notice of deficiency which is sent does not determine a deficiency, but only determines a fraud penalty. Where the entire tax and assessed interest has been paid and the Service determines that the entire initial failure to pay was due to fraud, the notice of deficiency should determine a fraud penalty composed of two parts. The 6653(b)(1) portion, equal to 50% of the tax liability, and the 6653(b)(2) portion, equal to 50% of the interest payable under section 6601 even though some of or all of the section 6601 interest was paid before the notice was issued.

While we agree that the 6653(b)(2) penalty is computed on the entire underpayment (tax liability) under the facts as stated in your memorandum, we suggest modification of your memorandum to give a more detailed explanation of how the notice of deficiency should be prepared when the entire correct tax has been assessed based on a delinquent return.

ROBERT P. RUWE
Director

By: 

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